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SIPDIS

STATE FOR SCA/CEN M. O'MARA

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TAGS: PGOV PREL EPET KZ
SUBJECT: KASHAGAN UPDATE: GOK CONFIRMS DELAY OF COMMERCIAL PRODUCTION

REF: A. DOE FOR EKIMOFF
¶B. COMMERCE FOR HUEPER

Classified By: AMBASSADOR ORDWAY FOR REASONS 1.4(B) AND (D)

1.(C) Summary: Representatives from the Kashagan consortium met with their Kazakhstani counterparts in Astana the week of June 23 in an effort to reach final agreement on a new commercial development plan for Kashagan. The two sides reached a tentative understanding in January, but the Kazakhstanis subsequently disagreed with a draft budget submitted by the consortium. On June 27, the parties signed two memoranda, one postponing the start of commercial production until 2013, the other confirming the fixed tax regime for the consortium. A prolonged standoff was unlikely, with both sides negotiating from vulnerable positions. End Summary

¶2. (C) Representatives from the Kashagan consortium travelled to Astana on June 23 to resume negotiations with the GOK. The two sides reached a tentative agreement in January, with the consortium agreeing to pay Kazakhstan up to $5 billion for project delays, double the stake of KazMunayGas, and replace Eni as sole operator of the project. In May, however, Kazakhstan asked for "more money and more value," ExxonMobil General Relations and Public Affairs Director for Kazakhstan Patty Graham told Poloff on June 19. Nevertheless, both sides have demonstrated good faith in trying to finalize an agreement, Shell's Country Manager Campbell Keir told the Ambassador on June 23.

¶3. (SBU) On June 28, Energy Minister Sauat Mynbayev announced that the GOK has agreed to postpone the start of commercial extraction at Kashagan from 2011 to 2013. If extraction is delayed beyond October 1, 2013, Kazakhstan will not compensate the consortium for its subsequent expenses, he said. According to Mynbayev, the two sides also signed a second memorandum on the tax regime for the PSA. The agreement calls for "old taxes plus new estimates of royalty." The tax regime for the PSA will thus remain unchanged and not affected by new export duties and extraction taxes, but the royalty rates will be increased.

¶4. (C) Several western oil company representatives close to the negotiations noted that KazMunayGas is under increased financial pressure. Graham described KMG as "in survivor mode" as they cope with a number of significant projects, including the purchase of a stake of MangistauMunaiGas (MMG), the acquisition of RomPetrol, the development of the "N" Block and String of Pearls fields, and the construction of the Pri-Kaspisky gas pipeline. John Dabbar, Conoco Phillips Transportation Manager for Russia and Eurasia, told DCM on June 26 that the Kazakhstanis are maintaining a confident attitude in public, but that "when the door closes, the begging starts." Shell Country Manager Campbell Keir told the

Ambassador that KMG seems short of money and that rumors abound that changes will occur after the July 6 national holiday, including KMG increasing its share of MMG from 51 to 71 percent (Comment: KMG may need to tighten its belt, but it is hardly headed for the poorhouse. Just last week, KMG floated five- and ten- year bonds worth three billion dollars) .

¶5. (C) The western oil companies are not in a better bargaining position, as they face damaging production delays. During the final weeks of negotiations, ConocoPhillips' Country Manager Nick Olds reported that the Kazakhstanis were only approving two to three weeks of work at a time and withholding approval of the overall budget. According to Shell's Keir, costs are increasing at Kashagan because of the mounting costs of transporting and operating equipment, ironically because of rising oil prices. Like Olds, he noted that the Kazakhstanis had not approved the new budget and called it one of the factors delaying first oil production (Comment: If, as we expect, KMG now approves the budget, it in fact will have no impact on any further delays). ExxonMobil's Graham said that without action the consortium risks losing steel mill slots for 9-18 months. She estimates that the eroded value of the project is already 50% (Comment: Graham did not explain how she reached this figure, and much, if not all, of the blame for the delays rests with the consortium)

¶6. (C) The two sides are moving forward on finalizing an operating agreement, said Keir. According to Olds, Total will run the new joint operating company, with Shell responsible for phase two offshore development and ExxonMobil subsoil and drilling. Eni will complete phase one development and remain

responsible for phase two onshore activity. KMG will assume operatorship when they are capable (Comment: A date not likely in the near future).

¶7. (C) Although the new operating structure appears set, the road ahead for the troubled project remains difficult. Graham told Poloff that the Kazakhstanis assumed that when Eni was replaced Shell and ExxonMobil would assume the operatorship and "carry things home" on the project. Such an easy solution is not realistic at this point, said Graham, which displeases the Kazakhstanis. Keir told the Ambassador that "getting from where we are now to where we want to be is not going to be pretty, especially for Eni."

¶8. (C) Comment: The GOK and the Kashagan consortium took the first steps to resolving their conflict in January, but reaching a final agreement has proven difficult. Nevertheless, with both sides now increasingly exposed, pressure is escalating to find common ground. The positive developments of the last week are a hopeful sign that the GOK and the consortium are ready to move beyond the acrimony of ¶2007. Ultimately, both the GOK and the IOCs need each other, and have too much riding on the project to let it fail. End Comment.

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